Managing an investment process during market volatility

Times of market volatility test the mettle of an investment process and often action or inaction during these periods has an outsized impact compared to decisions made during calmer times. Market falls can trigger behavioural investing biases that range from fear to loss aversion, or indeed denial that the investment story has changed. When developing our investment process, we focused on three principles to help us during market downturns: discipline, perspective and incremental change.

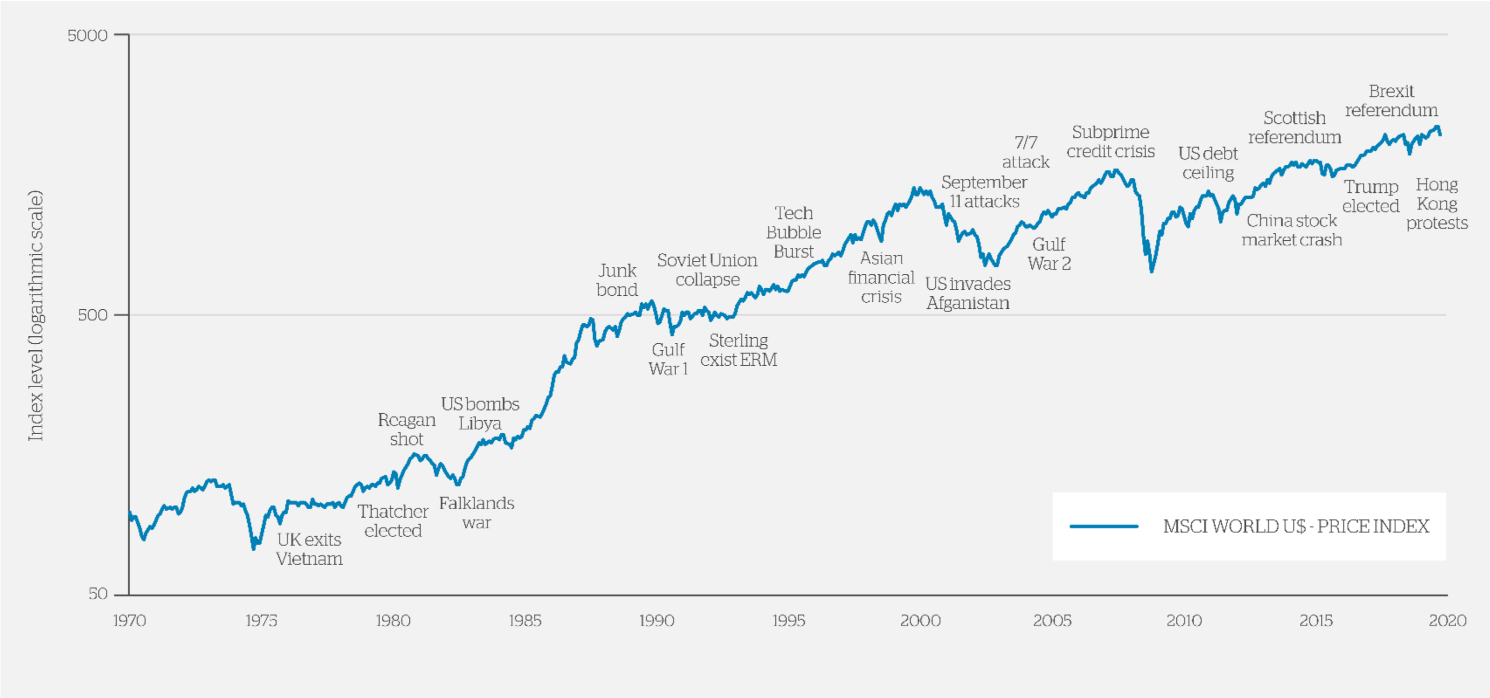
Discipline
For each of the risk profiles we manage on behalf of clients, we set an equity range. The idea behind this is to set expectations with our clients, but also to maintain discipline when fear or greed are capturing the mind of the market. During times of intense market volatility, when day-to-day moves in the market can be sharp and appear almost disconnected to news flow, it may be tempting to sit on the side-lines and disinvest, but an equity range provides discipline to avoid losing perspective.

Perspective
Each crisis is different and makes calling market moves from one day to the next very difficult. During these times, our process tells us to take a longer-term view in line with the investment horizon of our clients. There are some very good rules of thumb that can be used here, not to tell you whether markets will rally in the next week but to tell you whether equities are now cheap compared to history, or other asset classes. We look at the valuation levels of equities and make some conservative estimates around what might happen to earnings given the crisis at hand. We then compare the 'yield' on equities to that available in the bond market, specifically government bonds. While equities are clearly far more volatile than bonds, they do make a meaningful comparator as when risk sentiment does return asset allocators need to choose somewhere to invest. As a result, relative valuations help tell us where they might do so and, therefore, which asset class will be an outsized performer.

Incremental change
Due to the unknowns during a crisis, and in particular some of the short-term irrationality that becomes present in the market, it is not a time to make heroic swings of the investment bat. As a result, when we do make changes, our process tells us that communicating the path of travel to our clients and making small steps towards increasing or decreasing risk is the best method. During times of heightened volatility, we therefore may add one or two percent to equities each month when we sense longer term value.

While the coronavirus crisis is unique, it does look like many other crises (*figure 1)* and therefore, we are sticking to our investment process playbook for such situations. We feel equities are oversold on our longer-term metrics so have increased equity by one percent in our March Asset Allocation meeting - ahead of further increases if equities continue to fall. By keeping the longer-term perspective, we are able to maintain a path through volatility, while avoiding some of the behavioural biases that inevitably rear their heads at this time.

Figure 1



Source: Brooks Macdonald, MSCI: please see important information. As at March 2020.

Important information

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